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Revival of the independent contractor issue

American Institute of Certified Public Accountants. Tax Division;

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SEPTEMBER 1991

AICPA American Institute of Certified Public Accountants
1455 Pennsylvania Avenue, N.W., Washington, D.C. 20004–1007

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NOTICE TO READERS

Tax practice guides are designed as educational and reference material for the members of the Tax Division and others interested in the subject. They do not establish standards or preferred practices.

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INTRODUCTION

Since the passage of §530 of the Revenue Bill of 1978 with its safe harbor provisions, issues involving the classification of workers as employees or independent contractors have been raised less frequently. However, the Internal Revenue Service has recently adopted a practice of targeting for examination the employment tax status of workers in selected industries. Each district director targets industries that he thinks are appropriate for his district. It is expected that this examination practice will generate substantial litigation in the independent contractor area.

This practice guide reviews the factors considered by the Internal Revenue Service and the courts in classifying workers as employees or independent contractors. It is intended to aid the practitioner in structuring agreements between parties in independent contractor relationships in ways that will survive audit challenges.

OVERVIEW

Consequences of Classification

Classification of a worker as an employee or an independent contractor has significant tax consequences. If the worker is classified as an employee, his wages are subject to the employee's one-half of federal insurance contribution taxes that the employer is required to withhold from the employee's pay. I.R.C. §3102(a). The employer is required to pay a matching tax. I.R.C. §3111. For 1991, the tax rate is 7.65 percent for both employers and employees. The old age, survivors, and disability insurance taxable wage base is $53,400, while the Medicare wage base is $125,000. Additionally, the employer is required to withhold income taxes on wages paid to an employee. I.R.C. §3401.

If the employer is a sole proprietor or partnership, the individual employer or the general partners are personally liable for all taxes described above. Additionally, if the employer is a corporation, any responsible officer of the corporation has personal liability for willful failure to withhold the employee's share of the FICA and withheld income taxes, which are designated trust fund taxes by I.R.C. §6672. Third parties (lenders, sureties, etc.) who pay wages directly to an employer's employees or an agent for the employees, are liable for all taxes required to be withheld from such wages. Likewise, if a third party supplies funds for an account of an employer that is to be used for paying wages, he can be liable for all taxes not paid over to the United States, limited to an amount equal to 25 percent of the amount supplied to or for such account. I.R.C. §3505.

In addition to these federal taxes, classification as an employee will subject the employer to payment of federal unemployment tax in respect to compensation paid (for 1991, 6.2 percent of the first $7,000 in wages subject to credit for state unemployment insurance on all but 0.8 percent) and will subject the employer to various employment taxes imposed at the state level. Workers' compensation laws could also subject the employer to additional costs if the worker is classified as an employee. Additionally, classification as an employee may require that the employee be included in pension plans and other fringe benefit programs, which would not be applicable in the event of an independent contractor classification.

If the employer fails to withhold FICA taxes, the employer is still liable for payment under I.R.C. §3102(b). The government takes great umbrage to the nonpayment of employment taxes because the government is required to give the employees credit for payment of social security taxes, even if the taxes are not paid by the employer.

If a worker is categorized not as an employee but as an independent contractor, amounts earned by the worker from self-employment are subject to self-employment tax, the rate of which is now equal to the combined FICA taxes imposed on wages paid to employees. The combined FICA taxes paid by an employer and employee, less the tax benefit to the employer, are approximately the same as the self-employment tax paid by an independent contractor, less his deduction of one-half the self-employment tax. See I.R.C. §1401 and §1402.

Motivation of the Parties

Independent of tax consequences, there are a number of factors that drive operators of businesses to classify their workers as independent contractors. In the construction industry and other industry areas where the volume of work is unpredictable, there is a strong desire by the business owners to match labor to business needs and not to be encumbered by large permanent payrolls. Ten years ago when there was a booming housing market, homebuilders found it efficient to maintain full-time employees in all the skilled trades and to build in assembly line fashion. In today's soft market, homebuilders subcontract every part of their construction and employ no construction workers. This change was market-driven.

The employer is also motivated to classify the worker as an independent contractor because the classification greatly simplifies the accounting burdens of the business owner for tax and fringe benefit purposes, and can limit the employer's tort liability.

Another reason that some companies may prefer to work with independent contractors rather than employees is because the laws dealing with unions and collective bargaining generally apply to employees and not to independent contractors. However, the National

Labor Relations Board, similar to the IRS, may reclassify the independent contractors as employees if the facts so indicate.

From the worker's point of view, a worker with a skill can generally earn more as a contractor working for a variety of customers than he could on straight salary working for a single employer. The worker may also take pride in being independent of a boss supervising the details of his work. In addition, due to the high cost of mandatory employee benefits, independent contractors may receive substantially more cash at a lower cost to the company than employees. Many workers may prefer to be classified as independent contractors because they would rather receive more cash in hand and fewer non cash benefits.

From the government's point of view, if workers are classified as employees, taxes are withheld and paid over at the source. The burden is on the workers to file income tax returns and obtain refunds. Compliance problems are minimal. On the other hand, when the employer does not withhold, the pattern of workers making estimated tax payments is spotty and compliance problems increase dramatically. The unstated motivation of the government pushing to classify workers as employees is that the government wants withholding at the source to eliminate the compliance problems that come with self-employment.

Factual Nature of Problem

Classification of a worker as an employee or an independent contractor turns on the common law definition of "employment." This is a complex factual problem involving many factors that has led to a great deal of detailed analysis of different job categories under the common law standards. The case law and revenue rulings provide some guidance in this area, but the problem remains an inherently factual one that is subject to continuing controversy and litigation.

In order to characterize workers, common law principles, statutory rules of workers' compensation, and employer tort liability as well as the twenty-factor test developed by the Internal Revenue Service must be reviewed. See Rev. Rul. 87-41, 1987-1 C.B. 296, and Treas. Reg. §31.3401(c)-1(a) and (d). The Internal Revenue Service test includes the following factors:

1. Degree of Control,
2. Right to Discharge,
3. Right to Delegate Work,
4. Right to Hire and Fire Assistants,
5. Payment by the Hour,
6. Furnishing of Training,
7. Skill,

8. Duration of Relationship,
9. Control over Hours of Work,
10. Independent Trade,
11. Furnishing of Tools,
12. Place of Work,
13. Profit and Loss,
14. Intent of the Parties,
15. Principal in Business,
16. Sequence of Work,
17. Reports Required,
18. Same Work as Others Classified as Employees,
19. Integration, and
20. Industry Custom.

Under the common law definition of "employment," the most important factor for consideration is whether the employer has the right to instruct and control the employee in respect to the details of the work that is performed by the employee.

Resolution of an issue in this area requires an evaluation of the above factors as they apply to the particular facts of the case. None of the factors are controlling and, because of the great number of factors, it is difficult to find a case in which all of the factors indicate a definite characterization. Consequently, when a revenue agent begins working on one of these cases, he can be expected to resolve questionable issues in favor of the government and to determine that an employment situation exists.

Statutory Employees

Under I.R.C. §3121(d) and §3306(i), the Code creates categories of statutory employees. In addition to including any officer of a corporation, any common law employee, and certain employees of state and local governments, the Code specifically states that the following are statutory employees:

(1) a driver, paid as an agent or on commission, who distributes meat products, vegetable products, food products, bakery products, beverages (other than milk), or laundry or dry cleaning services;

(2) a full-time life insurance salesman;

(3) a homeworker performing work, according to specifications furnished by the person for whom the services are performed, on materials or goods furnished by such person to whom the materials or goods are returned upon completion of the services; and

(4) a full-time traveling or city salesman who solicits and transmits orders on behalf of a single principal from wholesalers, retailers, contractors, or operators of hotels, restaurants, or other similar establishments.

A worker who falls within one of the above-stated categories will be deemed an employee, for FICA and FUTA purposes, unless the worker has a substantial investment in the facilities used in connection with the performance of the services, other than transportation vehicles, or unless the services are in the nature of a single transaction that is not part of a continuing relationship.

Are statutory employees entitled to deduct business expenses on Schedule C? The provisions of I.R.C. §62(a) deny such deductions related to the performance of services as an employee. However, Rev. Rul. 90-93 provides that a statutory employee's business expenses are deductible on Schedule C because statutory employees are not employees for §62 purposes.

Statutory Independent Contractors

In addition to defining certain workers as employees, the Code also provides that two classes of workers are statutory independent contractors. The two classes are real estate agents and direct sellers. I.R.C. §3508. To qualify, a real estate agent must be licensed, and a direct seller must be engaged in the trade or business of selling or soliciting the sale of consumer products. Furthermore, a worker will meet the requisites of §3508 only if:

(1) substantially all of the remuneration for the services performed is directly related to sales or other output rather than to the number of hours worked; and

(2) the services are performed pursuant to a written contract between the worker and the service recipient and such contract provides that the worker will not be treated as an employee for federal tax purposes.

I.R.C. §3508 and Treas. Reg. §31.3508-1.

§530 of the Revenue Bill of 1978

In response to a flood of litigation in the independent contractor area, Congress enacted §530 of the Revenue Bill of 1978. This Act provides generally that if a business:

(1) did not treat an individual as an employee for any period,

(2) filed all tax returns (including Forms 1099) on a basis consistent with its tax position, and

(3) had a "reasonable basis" for treating the worker as an independent contractor,

the government is not to raise the employment tax issue in an examination.

A reasonable basis that is acceptable under §530 includes having a case or ruling that supports the taxpayer's position, a previous IRS audit in which the independent contractor treatment resulted in no assessment, or a long-standing industry practice.

When a "safe haven" under §530 is found, a company is not subject to back taxes or penalties, or obligated in the future to withhold income taxes from contractor payments or pay employment taxes on independent contractors. However, §530 has been targeted for modification or repeal.

Attached as appendix A is a flowchart used by the Internal Revenue Service regarding §530 determinations.

It is also important to note that §530 only provides protection for federal employment tax problems. While it may be persuasive for other federal tax purposes, it does not extend any further than the employment tax area. For example, §530 would not provide a safe harbor in a pension plan case. In addition, §530 does not bind state authorities.

Current Government Audit Focus

In March of 1988, the IRS issued a news release announcing a nationwide collection program focused upon independent contractors. Since that time, the IRS has significantly increased enforcement efforts, issuing a number of private letter rulings that generally classify workers as employees.

State Developments

State governments have also stepped up enforcement in the independent contractor area. Companies in Illinois, Kansas, and Texas have been hit particularly hard by state investigations. Also, the state governments and the Internal Revenue Service exchange information on a regular basis during investigations of this type.

Consequences of Adverse Determination

The consequences of an adverse determination in the employment tax area can be devastating to a business entity. These cases generally involve two or three open years. In an industry that is labor intensive, a liability of 15 percent of a payroll plus penalties and interest generate deficiencies that are so large in proportion to income and assets that bankruptcy of the business and its owners is a frequent consequence.

I.R.C. §3509 - Reduced Employment Tax Liability

The large deficiencies in an employment tax case can be mitigated by I.R.C. §3509, which provides reduced employment tax liability to employers for certain recharacterizations of workers if the employer does not intentionally disregard the reporting requirements. If Forms 1099 are filed with respect to the workers, the employer will have a 1.5 percent liability for income tax withholding and must pay the employer's share of FICA plus 20 percent of the employee's share of FICA. If Forms 1099 are not filed, the employer will have a 3.0 percent liability for income tax withholding and must pay the employer's share of FICA plus 40 percent of the employee's share of FICA. §3509 does not apply to FUTA tax liability, nor is any adjustment available under this section regarding interest and penalties.

Even with the reduced tax rates under §3509, the absolute dollars involved in a deficiency can be staggering. In addition to the tax costs, the time and resources spent with accountants and lawyers and the time and resources devoted by the business owner in handling an employment tax issue can be vast.

I.R.C. §§3402(d) and 6521 - Special Abatement Rules

It is important to note that, under I.R.C. §3402(d), an employer is entitled to a credit against the retroactive assessment of federal income tax withholding liability if the employer can prove that the worker reported the income covered by the assessment. The relief under §3402(d) is not available if the §3509 reduced tax rates apply.

Additionally, in retroactive recharacterization of worker situations, I.R.C. §6521 provides for the mitigation of the effect of the statute of limitations on obtaining a refund of FICA or SECA taxes. This type of relief is also unavailable if the §3509 reduced tax rates apply.

Occasionally, however, the IRS Appeals Division will settle cases with allowances. They have, in fact, settled by computing the FICA tax on the compensation paid to the employee/ contractor, net of the employee/ contractor's expenses.

AREAS OF SERVICE

Pre Audit Review

One of the most valuable services to a client will be that of undertaking a rigorous review of the work situation to structure or restructure the relationship in such a way that questions will be resolved in the manner desired by the company in the event of an audit. This is best done by review prior to the audit.

When a client classifies workers as independent contractors, consider the following:

(1) Is it likely that a revenue agent will make an adjustment to this classification?

(2) If so, would the client's life be simpler if he were to reclassify the workers as employees?

(3) Does the problem justify the expense of a rigorous review? Consider the cost of a two- to three-year audit with an adverse determination. Would this put the client out of business?

(4) If there are good reasons to maintain independent contractor status, what can be done to reduce the risk?

If at this point there is a very substantial risk to the client, the appropriate remedy is to do a rigorous review of the situation in order to fully understand the facts and then to either persuade the client that he needs to start treating the workers as employees or to structure the relationship between the client and the workers in such a way that their status as independent contractors will have minimum audit exposure. Involvement of counsel at this point could be helpful to draft appropriate contracts and to furnish a litigation point of view.

The following is an analysis of the factors that need to be considered in the review and documented to the extent possible:

1. **Degree of Control.** The most important factor is that of whether the person hiring the worker has the right to supervise and control the details of the work being done. The other factors are evidence of control. The contract should state that the company has no right to control the method or manner of the job to be performed by the worker, and the actual practice of the parties must conform to the contractual terms. It would also be advantageous for the company to sign a separate letter or memorandum of acceptance on completion of the work stating that the terms of the contract were met.

2. **Right to Discharge.** The independent contractor relationship is contractual in nature. Without incurring liability for breach of contract, the company cannot terminate the independent contractor so long as he meets his obligations under the agreement. An employer, on the other hand, can traditionally fire an employee for good cause, bad cause, or no cause, and an employee has the right to quit without liability. In an independent contractor relationship, there should be no evidence of the company's right to fire the worker at will. The contract should so state. If the company is unhappy with a worker, it should simply decline to give him work on a subsequent job.

3. **Right to Delegate Work.** The contract between the company and the worker should state that the worker has the right to bring in whomever he pleases to accomplish the purpose of the contract. Such a provision helps establish that the assistants of the worker are his employees and not employees of the company. Also, the contract should provide that the independent contractor will treat his assistants as his own employees and will comply with all tax requirements.

4. **Right to Hire and Fire Assistants.** The right to hire and fire assistants by the employer is evidence of control over the persons on the job. If the contract between the company and the worker states that the worker agrees to provide the labor and is responsible for nothing other than attaining the intended result, there is further evidence of the worker's status as an independent contractor. Including the right to delegate and to hire and fire assistants in the contract is beneficial even if the right is never exercised, and even if the parties never expect it to be exercised.

5. **Payment by the Hour, Week or Month.** An employee is generally paid by the hour, week or month, while an independent contractor is paid by the job. To avoid recharacterization, the company should structure the worker's pay as an agreed sum or according to an agreed formula for a given job.

6. **Furnishing of Training.** The company should not provide any type of training for inexperienced workers. Inexperienced workers should contact the independent contractor for training on an employer-employee basis.

7. **Skill.** Independent contractors are generally viewed as skilled workers. Less skilled workers are more likely to be classified as "employees."

8. **Duration of Relationship.** An independent contractor is generally hired for a specified time period, usually the length of time necessary to complete a specific job. An employee relationship is generally continuous and indefinite in length. Thus, the contract should set out either a completion date or some other termination date of its relationship with the independent contractor.

9. **Control Over Hours of Work.** If the company sets hours of work, an employer-employee relationship is indicated. The workers should be allowed to set their own hours without any supervision, other than reasonable requests from the company such as asking that work not be performed during specified hours.

10. **Independent Trade.** To establish that the worker is involved in an independent trade, he should not be required to work full-time for the company. The worker should be free to work for any number of persons or firms simultaneously. Also, to enhance the independent contractor relationship, the worker should advertise and project himself to the public as an independent contractor in business for himself. Document evidence of the independent contractor's separate business with copies of business cards, ads in yellow pages, and business letterhead.

    Also, the contract should specifically mandate that the worker obtain and be responsible for all required business licenses and/ or registrations. The company should then verify that the licensing requirements have been met. Furthermore, in states where any type of state excise or franchise tax is applicable to service-oriented businesses, the worker should be contractually required to, and should in fact, pay such tax.

11. **Furnishing of Tools.** The company should require the worker to provide his own tools whenever possible. This is evidence of the company's lack of control over the worker. It also indicates that the worker has made a substantial investment in the tools and equipment needed for his job, which is further evidence of the independent contractor relationship. If company equipment is used by the contractor, let the contractor pay rent. Document it.

12. **Place of Work.** Whenever possible, the worker should perform his job off the company's premises. Working on the premises indicates that the worker is within the company's control.

13. **Profit and Loss.** If possible, the worker should have the opportunity to negotiate payment under the contract with the company so as to provide the worker with an opportunity for profit or loss. The company should also obtain information regarding the worker's average investment in trucks and equipment because this affects the worker's potential for profit or loss. Furthermore, the contract should provide that the customer will pay the worker directly, if possible, so that the worker will bear the risk of loss.

14. **Intent of the Parties.** The parties' intent to create an independent contractor relationship should be documented in all correspondence between the parties. The company should always refer to the worker as an independent contractor in letters, memoranda, invoices, and check stubs.

15. **Sequence of Work.** The company should not instruct the worker as to the sequence in which the work should be performed. The company should only direct the outcome of the work and not the manner in which it is done.

16. **Reports Required.** The company should not require the worker to submit regular oral or written reports; nor should the company require the worker to attend regular company meetings. The company should also refrain from sending supervisors or inspectors to the field to check on the progress of the worker. The contract with the worker should state that the work must be performed to the customer's satisfaction so that there is no need of further supervision. However, if it is necessary that the company retain a right to inspect the work performed, the contract should give the company the right to inspect the results of the services performed, as opposed to the method used to achieve the results.

17. **Same Work as Regular Employees.** The company should not have the independent contractor do the same type of work as its regular employees.

18. **Integration.** It is important to establish that the worker is carrying on an individual business rather than working in the course of the company's general business. The company should not engage an independent contractor to do something that is a part of the day-to-day operations of the company.

19. **Industry Custom.** What are the client's competitors doing? Is there a clear industry custom that can be proved by testimony of competitors?

Attached as appendix B is a checklist, which can be used by the practitioner to determine whether independent contractor status is evident.

In some cases, the taxpayer may be tempted to obtain a ruling. A favorable ruling would be helpful because it would place the taxpayer within the §530 safe harbor if the taxpayer's facts correspond to the ruling factors. The Service provides a Form SS-8 for requesting determinations as to whether a worker is an employee or an independent contractor. However, that form should not be filed because it is used as a lead source for employment tax examinations. I.R.M. 4631.3. It is estimated that 90 percent of the SS-8 requests result in employee determinations.

Other Suggestions

In addition to those suggestions stated above, the company involved in an independent contractor relationship should consider the following:

1. **Insurance.** The company should not provide any type of liability or health insurance to the workers. The company should insist that the workers carry their own liability insurance.

2. **Benefits.** The company should not provide the worker with bonuses, paid sick leave or paid vacation time. Likewise, the company should not cover the worker under any type of deferred compensation arrangement such as a pension plan or profit-sharing plan.

3. **Expenses.** The worker should be responsible for obtaining any required licenses and for payment of those licenses. The worker should also pay for any meal and transportation expenses incurred in the performance of the contracted job. Pay the worker more. Let him pay for these expenses.

The Audit

The internal audit checklist approach outlined above assumes that you have the leisure to work on this problem without harassment by a revenue agent or a representative of a state taxing authority. If the client is being audited without the benefit of the review suggested above, the approach to the problem changes materially.

In an audit, it is necessary to prepare the evidence carefully that will determine the classification of the worker. It is the responsibility of a revenue agent to make uncertain factual determinations in favor of the government in order to protect the government's interest. Employment tax audits involve mixed fact questions, and the probability of an adverse determination is high. Consequently, accountants faced with examinations involving employment tax issues in which it is clear that favorable resolution will not be achieved, or in instances where the IRS Criminal Investigation Division is involved or could become involved, should plan for litigation of these issues and should involve counsel on the first indication that the above factors are present. Obviously, counsel with a track history in handling employment tax issues should be sought.

When an employment tax issue arises, the company should immediately develop a questionnaire based upon the twenty-factor test used by the I.R.S. Attached as appendix C is a copy of the test used by the Internal Revenue Service, which is found in the Internal Revenue Manual. Representatives of the company should conduct recorded interviews of each of the workers to obtain documented answers to the questionnaire. After each worker has been interviewed, it would be helpful to incorporate the interview responses into an individualized affidavit to be signed by each worker.

As soon as all of the interviews have been conducted and the affidavits have been prepared, the information and documentation should be assembled in one binder accompanied by a brief discussing the legal issues involved. The brief and binder of information can then be

handed to the revenue agent to bolster his files so that he is in a position to concede the case. The completed questionnaire also provides documentation of the workers' initial responses in the event of litigation.

Another fact that must be developed is the amount of the employer's potential employment tax assessment for FICA and withholding taxes that has been paid by the workers as income or self-employment tax. The burden of proof for establishing the amount is on the taxpayer. However, there is a line of cases discussed in Volume 414-2nd of the Bureau of National Affairs Tax Management Portfolio, which states that the taxpayer is entitled to copies of the employees' tax returns for the years in issue.

Once the employer has established the amount of tax paid by the employee, the employer should complete IRS Form 4669, which is an Employee Wage Statement, and file it with the Service.

Contesting I.R.S. Recharacterizations

Employment tax issues are initially raised by revenue agents in the scope of an examination of a business entity. However, frequently employment tax examinations are conducted by the IRS Collection Division. If the company does not agree with the determination of the revenue agent, it can file a protest and cause the determination of the revenue agent to be reconsidered by the Appeals Division or a Collection Division conferee. If the Appeals Division does not reverse the determination of the revenue agent, employment taxes are not subject to review by the United States Tax Court without payment of tax, as is the case with income and estate taxes. Rather, the taxes are assessed and can then be contested only by paying the employment taxes, filing a claim for refund of the tax paid, having the claim for refund denied by the Service, and bringing a suit for refund in the United States District Court or the United States Claims Court within two years after the date of payment of the tax or within three years after the filing of the tax return. The merits of an employment tax case can also be litigated in Bankruptcy Court.

In a case that is pending before the District Court or the Claims Court in a refund context, the Internal Revenue Service is not required to abate collection activity; but as a normal practice, it generally does. In a case pending before a Bankruptcy Court, the automatic stay will prevent collection activities unless the stay is lifted by a motion to the court.

Because employment taxes are deemed to be "divisible taxes," a taxpayer may file a refund suit in the District Court or Court of Claims based upon payment of the assessed tax attributable to one employee for a single tax period rather than pay the full amount shown on the return. The Justice Department will counterclaim for the full amount due. Penalties are also "divisible" for refund suit purposes.

I.R.C. §6413 - Claiming Adjustment of Overpaid FICA Taxes

I.R.C. §6413 applies when more than the correct amount of FICA tax is paid with respect to any payment of remuneration to the employee. If such a situation arises, adjustments are to be made in the manner specified by the Regulations. Under Treas. Reg. §31.6413(a)(2), if an employer repays or reimburses an employee in the amount of an overcollection of FICA tax, the employer may adjust the overcollection, without interest, by claiming a deduction on any employment tax return in the calendar year in which the repayment or reimbursement is made. This is done by filing IRS Form 941c, Statement to Correct Information, with the employment tax return.

Conclusion

Because of the complexities involved with independent contractor characterizations, the practitioner must carefully advise the client when faced with such issues. The practitioner should review in detail the relationship, which the client has created with an independent contractor, and inform the client of any possible exposure it may have as a result. With proper guidance by the practitioner, the client may successfully structure the independent contractor relationship by following relevant case law and statutory safe harbors so that the characterization will withstand IRS scrutiny.

REFERENCES AND BIBLIOGRAPHY

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Legislative History

H. Rep. No. 979, 101st Cong., 2d Sess. (1990).

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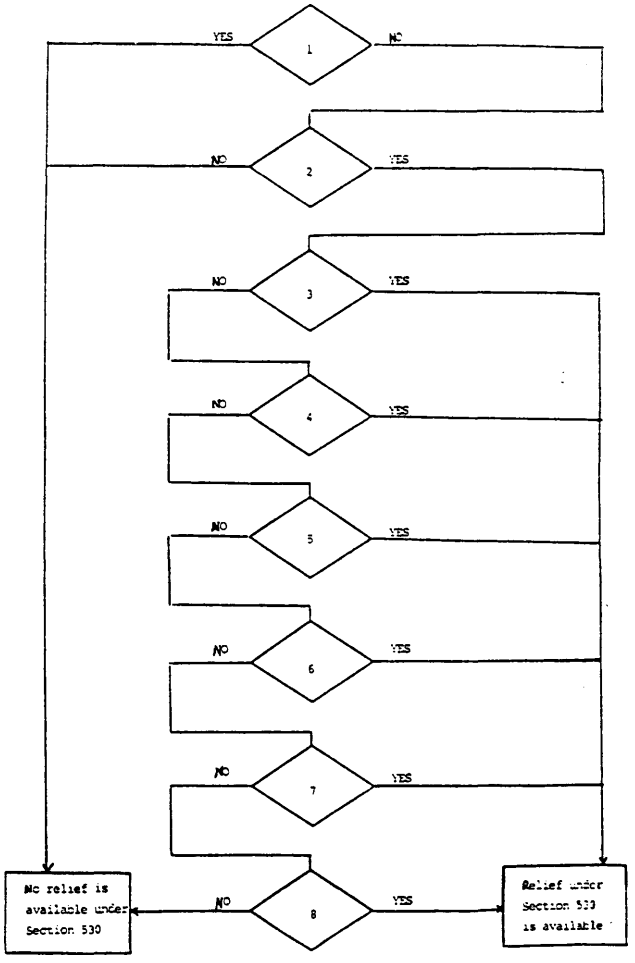
APPENDIX A

Section 530 Flowchart



Answer the eight questions in this Exhibit to follow the flowchart. The results will indicate if relief under Section 530 is or is not available to the taxpayer.

Section 530 Flowchart ◊

1. Has the taxpayer "treated" the individual or any other individual holding a substantially similar position as an employee during the period under examination or a prior period?
2. Were all Federal tax returns (including information returns, Form 1099) required to be filed for the period under examination by the taxpayer with respect to the individual filed on a basis consistent with treating the individual as not being an employee?
3. Is there a judicial precedent or published ruling under which the individual may reasonably be considered as not being an employee?
4. Has technical advice or other determination been issued with respect to the taxpayer indicating the individual (or a class of individuals) should not be treated as employees?
5. Does the taxpayer have a letter ruling indicating the individual (or a class of individuals) should not be treated as employees?
6. Was there a prior IRS examination for a period in which the taxpayer employed the individual (or the class of employees) in question and employment taxes were not an issue?
7. Is it a long-standing recognized practice of a significant segment of the industry to treat such individual as not being employees?
8. Did the taxpayer have any other reasonable basis for treating the individual as not being an employee?

[The next page is 8469.]

APPENDIX B

CHECKLIST FOR DETERMINATION OF INDEPENDENT CONTRACTOR STATUS

In order to establish an independent contractor relationship, the answers to the majority of the following questions should be yes.

		YES	NO
1.	Have the parties signed an independent contractor agreement?	___	___
2.	Does the contract state that the company has no right to control the work performed?	___	___
3.	Has the company prepared a letter upon the completion of the work stating that the contractual terms were complied with?	___	___
4.	Does the contract state that the independent contractor cannot be fired so long as he meets his contractual obligations?	___	___
5.	Does the contract state that the independent contractor has a right to hire and fire assistants?	___	___
6.	Does the contract state that the independent contractor will treat assistants as his own employees and will comply with all tax requirements?	___	___
7.	Does the contract provide that the independent contractor is solely responsible for providing the labor to achieve the intended result?	___	___
8.	Is the independent contractor paid by the job, rather than by the hour?	___	___
9.	Is the company ensuring that no type of training is provided by the company for inexperienced workers?	___	___

		YES	NO
10.	Is the independent contractor viewed as a skilled worker?	___	___
11.	Is the independent contractor hired for a specified time period?	___	___
12.	Does the contract set out a completion date or some other termination date of its relationship with the independent contractor?	___	___
13.	Does the independent contractor set his own hours of work?	___	___
14.	Is the independent contractor free to work for any number of persons or firms simultaneously?	___	___
15.	Does the independent contractor advertise and project himself to the public as an independent contractor in business for himself? Does he have business cards? Does he advertise on the side of his truck or van? Does he advertise in the yellow pages?	___	___
16.	Does the independent contractor furnish his own tools?	___	___
17.	Does the independent contractor perform his job off company premises?	___	___
18.	Does the independent contractor negotiate the payment for his services with the company?	___	___
19.	Does the contract provide that the customer will pay the independent contractor directly, rather than pay the company who then pays the independent contractor?	___	___
20.	Does the company consistently refer to the worker as an independent contractor in letters, memoranda, invoices, check stubs, and other correspondence between the parties?	___	___
21.	Does the company refrain from instructing the independent contractor as to the sequence in which the work is to be performed?	___	___

		YES	NO
22.	Does the company refrain from requiring the independent contractor to submit regular oral or written reports?	___	___
23.	Does the company refrain from sending supervisors or inspectors to the field on a regular basis to check on the work progress?	___	___
24.	Does the company refrain from requesting that the independent contractor do the same type of work as its regular employees?	___	___
25.	Does the company refrain from engaging an independent contractor to do something that is part of the day-to-day operations of the company?	___	___
26.	Is there evidence that the company's competitors are treating similar workers as independent contractors?	___	___

APPENDIX C

(2) If an employer erroneously paid RRTA taxes with respect to the compensation of employees for services which are held to be covered under the Federal Insurance Contributions Act, FICA returns must be filed for each return period involved. The wages paid to all employees involved and the employer tax and employee tax applicable thereto must be reported on such returns. Credit must be claimed on each FICA return for RRTA employer tax and employee tax erroneously paid for the corresponding return periods to the extent necessary to satisfy the FICA liability disclosed, supported by credit claims on Form 843. The amounts shown on the credit claims should not exceed the amount of FICA taxes reported on the returns. After credit has been properly applied, the net tax will be zero. The employer is also entitled to file claim for refund on Form 843 for the difference between the total RRTA tax erroneously paid and the amount taken as credit on the FICA returns to the extent that refund is not barred by the statutory period of limitations on refunding of tax.

4645 *(5-6-86)*
Special Rules Relating to FUTA and RRTA Taxes

If an employer erroneously paid FUTA tax on service covered under RURT (Chapter 23a of the Code), then the examiner should recommend the overassessment of the FUTA tax and transfer of the funds to RURT, with the balance if any applied to any RRTA tax due. If any additional amount remains after application to the above liabilities, the balance should be disposed of in accordance with IRC 6402.

4646 *(5-6-86)*
Determination of Employer-Employee Relationship

(1) Exhibit 4640-1 contains factors that determine control in the common law employer-employee relationship. Exhibit 4640-2 contains the requirements of statutory employees under FICA. The guidelines in Exhibits 4640-1 and 2 were derived from the Social Security Administration Claims Manual.

(2) Examiners will find the guidelines in Exhibits 4640-1 and 2 valuable in cases in which it is necessary to make an employer-employee relationship determination. These guidelines are strictly training materials and may not be cited to a taxpayer as authority for a determination.

(3) When involved in a case requiring an employer-employee relationship determination, the examiner will compile information bearing on the factors explained in Exhibit 4640-1. This information should include documents not only indicating whether a factor exists, but the reason for its existence. Evaluating such information will generally enable the examiner to resolve the employer-employee relationship question by applying law, regulations, or a clearly applicable ruling.

(4) To be covered as a statutory employee, a worker must meet general requirements prescribed for all categories and then specific requirements prescribed for the category the worker is qualifying under. (See Exhibit 4640-2.) Before determining statutory coverage, the examiner should first determine that the worker is not a common law employee.

(5) IRC 3508 provides that an individual who performs services after December 31, 1982, as a qualified real estate agent or as a direct seller shall not be treated as an employee and the person for whom such services are performed shall not be treated as an employer.

(6) Many controversies have developed between the Service and taxpayers concerning the proper determination of the employer-employee relationship. Consequently, Section 530 of the Revenue Act of 1978 was enacted to provide interim relief to taxpayers involved in such controversies. See IRM 46(10)2. Exhibit 4640-3 may be used to assist the examiner in determining if relief under Section 530 is available to the taxpayer.

(7) Questions arising in employer-employee relationships which cannot be resolved by the examiner should be referred to the National Office for technical advice in accordance with IRM 4550 and IRM 4631.

4647 *(5-6-86)*
Tax Status in Special Cases

For treatment of special types of employment and special types of wage payments for employment tax purposes, the examiner should refer to Publication 15, Circular E—Employer's Tax Guide, for quick research on an issue. However, the Code, regulations, revenue rulings, and court decisions are the authority for any issues being proposed.

Exhibit 4640-1

Employer-Employee Relationship ◊

Introduction

For FICA, FUTA, and income tax withholding purposes the term "employee" (Secs. 3121(d), 3306(i), and 3401(c)) includes any individual who, under the usual common law rules applicable in determining the employer-employee relationship, has the status of an employee.

The Common Law Rules—Factors

Under the common law test, a worker is an employee if the person for whom he works has the right to direct and control him in the way he works both as to the final results and as to the details of when, where, and how the work is to be done. The employer need not actually exercise control. It is sufficient that he has the right to do so.

If the relationship of employer and employee exists, it is of no consequence whether the employee is designated as a partner, coadventurer, agent, independent contractor, or the like. Furthermore, all classes or grades of employees are included within the relationship of employer and employee. Thus, superintendents, managers, and other supervisory personnel are employees.

The factors or elements that show control are described below in the following 20 items. Any single fact or small group of facts is not conclusive evidence of the presence or absence of control.

These common law factors are not always present in every case. Some factors do not apply to certain occupations. The weight to be given each factor is not always constant. The degree of importance of each factor may vary depending on the occupation and the reason for existence. Therefore, in each case the agent will have two things to consider: First, does the factor exist; and second, what is the reason for or importance of its existence or nonexistence.

Instructions. A person who is required to comply with instructions about when, where, and how he is to work is ordinarily an employee. Some employees may work without receiving instructions because they are highly proficient and conscientious workers. However, the control factor is present if the employer has the right to require compliance with the instructions. The instructions which show how to reach the desired result may be oral or written (manuals or procedures).

Training. Training a person by an experienced employee working with him, by correspondence, by required attendance at meetings, and by other methods indicates that the employer wants the services performed in a particular method or manner. This is especially true if the training is given periodically or at frequent intervals. An independent contractor ordinarily uses his own methods and receives no training from the purchaser of his services. In fact, it is usually his methods which bring him to the attention of the purchaser.

Integration. Integration of the person's services into the business operations generally shows that he is subject to direction and control. In applying the integration test, first determine the scope and function of the business and then whether the services of the individual are merged into it. When the success or continuation of a business depends to an appreciable degree upon the performance of certain services, the people who perform those services must necessarily be subject to a certain amount of control by the owner of the business.

Services Rendered Personally. If the services must be rendered personally, presumably the employer is interested in the methods as well as the results. He is interested in not only the result but also the worker.

Hiring, Supervising, and Paying Assistants. Hiring, supervising, and paying assistants by the employer generally shows control over the men on the job. Sometimes one worker may hire, supervise, and pay the other workmen. He may do so as the result of a contract under which he agrees to provide materials and labor and under which he is responsible for only the attainment of a result. In this case he is an independent contractor. On the other hand, if he hires, supervises, and pays workmen at the direction of the employer, he may be an employee acting in the capacity of a foreman for or representative of the employer (Rev. Rul. 70–440, 1970–2 C.B. 209).

Continuing Relationship. A continuing relationship between an individual and the person for whom he performs services is a factor which indicates that an employer-employee relationship exists. Continuing services may include work performed at frequently recurring though

Exhibit 4640-1 Cont. (1)

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somewhat irregular intervals either on call of the employer or whenever the work is available. If the arrangement contemplates continuing or recurring work, the relationship is considered permanent even if the services are part-time, seasonal, or of short duration.

Set Hours of Work. The establishment of set hours of work by the employer is a factor indicating control. This condition bars the worker from being master of his own time, which is the right of the independent contractor. If the nature of the occupation makes fixed hours impractical, a requirement that the worker work at certain times is an element of control.

Full Time Required. If the worker must devote his full time to the business of the employer, the employer has control over the amount of time the worker spends working and impliedly restricts him from doing other gainful work. An independent contractor, on the other hand, is free to work when and for whom he chooses. Full time does not necessarily mean an 8-hour day or a 5- or 6-day week. Its meaning may vary with the intent of the parties, the nature of the occupation, and customs in the locality. These conditions should be considered in defining "full time."

Full-time services may be required even though not specified in writing or orally. For example, to produce a required minimum volume of business may compel a person to devote all of his working time to that business; or he may not be permitted to work for anyone else, and to earn a living he necessarily must work full time.

Doing Work on Employer's Premises. Doing the work on the employer's premises in itself is not control. However, it does imply that the employer has control, especially when the work is the kind that could be done elsewhere. A person working in the employer's place of business is physically within the employer's direction and supervision. The use of desk space and telephone and stenographic services provided by an employer places the worker within the employer's direction and supervision. Work done off the premises indicates some freedom from control. However, this fact by itself does not mean that the worker is not an employee.

Control over the place of work is indicated when the employer has the right to compel a person to travel a designated route, to canvass a territory within a certain time, or to work at specific places as required. In some occupations services must be performed away from the premises of the employer; for example, employees of construction contractors or taxicab drivers.

Order or Sequence Set. If a person must perform services in the order or sequence set for him by the employer, it shows that the worker is not free to follow his own pattern of work but must follow the established routines and schedules of the employer. Often, because of the nature of an occupation, the employer either does not set the order of the services or sets them infrequently. It is sufficient to show control, however, if he retains the right to do so. The outside commission salesman, for example, usually is permitted latitude in mapping out his activities and may work "on his own" to a considerable degree. In many cases, however, at the direction of the employer he must report to the office at specified times, follow up on leads, and perform certain tasks at certain times. Such directions interfere with and take preference over the salesman's own routines or plans; this fact indicates control.

Oral or Written Reports. Another element of control is the requirement of submitting regular oral or written reports to the employer. This action shows that the person is compelled to account for his actions. Such reports are useful to the employer for present controls or future supervision; that is, they enable him to determine whether his instructions are being followed or, if the person has been "on his own," whether instructions should be issued.

Payment by Hour, Week, Month. Payment by the hour, week, or month generally points to an employer-employee relationship, provided that this method of payment is not just a convenient way of paying a lump sum agreed upon as the cost of doing a job. The payment by a firm of regular amounts at stated intervals to a worker strongly indicates an employer-employee relationship. (The fact that payments are received from a third party, e.g., tips or fees, is irrelevant in determining whether an employment relationship exists.) The firm assumes the hazard that the services of the worker will be

Exhibit 4640-1 Cont. (2)

Employer-Employee Relationship

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proportionate to the regular payments. This action warrants the assumption that, to protect its investment, the firm has the right to direct and control the performance of the worker. It is also assumed in absence of evidence to the contrary that the worker, by accepting payment upon such basis, has agreed that the firm shall have such right of control. Obviously, the firm expects the worker to give a day's work for a day's pay. Generally, a person is an employee if he is guaranteed a minimum salary or is given a drawing account of a specified amount at stated intervals and is not required to repay any excess drawn over commissions earned.

Payment made by the job or on a straight commission generally indicates that the person is an independent contractor. Payment by the job includes a lump sum computed by the number of hours required to do the job at a fixed rate per hour. Such a payment should not be confused with payment by the hour.

Payment of Business and/or Traveling Expense. If the employer pays the person's business and/or traveling expenses, the person is ordinarily an employee. The employer, to be able to control expenses, must retain the right to regulate and direct the person's business activities.

Conversely, a person who is paid on a job basis and who has to take care of all incidental expenses is generally an independent contractor. Since he is accountable only to himself for his expenses, he is free to work according to his own methods and means.

Furnishing of Tools, Materials. The fact that an employer furnishes tools, materials, etc., tends to show the existence of an employer-employee relationship. Such an employer can determine which tools the person is to use and, to some extent, in what order and how they shall be used.

An independent contractor ordinarily furnishes his own tools. However, in some occupational fields, e.g., skilled workmen, workers customarily furnish their own tools. They are usually small hand tools. Such a practice does not necessarily indicate a lack of control over the services of the worker.

Significant Investment. Investment by a person in facilities he uses in performing services for another is a factor which tends to establish an independent contractor status. On the other hand, lack of investment indicates dependence on the employer for such facilities and, accordingly, the existence of an employer-employee relationship.

In general, facilities include equipment or premises necessary for the work, such as office furniture, machinery, etc. This term does not include tools, instruments, clothing, etc., commonly provided by employees in their trade, nor does it include education, experience, or training.

In order for an investment to be a significant factor in establishing that an employer-employee relationship does not exist, it must be real, it must be essential, and it must be adequate.

Is investment real? Little weight can be accorded to a worker's investment in equipment if he buys it on time from the person for whom he does the work and if his equity in the equipment is small. The same is true if the worker purchases equipment from his employer on a time basis but the employer retains title to the equipment, has the option of retaining legal ownership by paying the worker the amount of his equity in the equipment at any time before the equipment is fully paid for, requires its exclusive use in the operation of his business, and directs the worker in its use. Such investments are not "real."

Is investment essential? An investment in equipment or premises not required to perform the services in question is not essential. For example, a photographers' model may have a large investment in a wardrobe; however, if she poses for a photographer who ordinarily requires that his models wear clothing he furnishes, her investment is not essential even though the photographer lets her use her own wardrobe as a matter of indulgence. The photographer hires her only for her photogenic qualities and her ability to pose; it is not required that she furnish her own wardrobe.

Is investment adequate? Ownership by an individual of facilities adequate for the work and independent of the facilities of another points to an independent contractor relationship. Ownership of such facilities is an influen-

Exhibit 4640-1 Cont. (3)

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tial factor in letting the contract of service. The important point is the value of the investment compared to the total value of all the facilities for doing the work. An investment in facilities is not adequate if the worker must rely appreciably on the facilities of others to perform the services. For instance, an individual who is engaged to perform a machine operation on his own premises and who furnishes his own equipment of substantial value may be a self-employed subcontractor instead of an employee of the manufacturer.

Significant in determining the weight of the investment factor is ascertaining who has the right to control the facilities. Ownership of equipment or premises points toward an independent contractor status because it is inferred that the owner has the right to control their use. However, if the owner, as part of the agreement, surrenders complete dominion over the equipment or premises and the right to decide how they shall be used, "ownership" loses its significance.

Suppose an individual who owns a truck is hired by a trucking company to deliver goods and materials to business firms. The fact that he uses his own truck to perform these services is not significant if, in general, the firm uses it like its own trucks. For example, the firm sets the order and time of deliveries; pays for all upkeep and repair of the individual's truck while used in its business or otherwise compensates the individual for these costs; restricts him from using the truck to perform services for others, etc.

Realization of Profit or Loss. The man who can realize a profit or suffer a loss as a result of his services is generally an independent contractor, but the individual who cannot is an employee.

"Profit or loss" implies the use of capital by the individual in an independent business of his own. Thus, opportunity for higher earnings, such as from pay on a piecework basis or the possibility of gain or loss from a commission arrangement, is not considered profit or loss.

Whether a profit is realized or loss suffered generally depends upon management decisions; that is, the one responsible for a profit or loss can use his own ingenuity, initiative, and judgment in conducting his business or enterprise. Opportunity for profit or loss may be established by one or more of a variety of circumstances, e.g.:

1. The individual hires, directs, and pays assistants.

2. He has his own office, equipment, materials, or other work facilities.

3. He has continuing and recurring liabilities or obligations, and his success or failure depends on the relation of his receipts to his expenditures.

4. He agrees to perform specific jobs for prices agreed upon in advance and pay expenses incurred in connection with the work.

5. His services and/or those of his assistants establish or affect his business reputation and not the reputation of those who purchase the services.

Working for More Than One Firm at a Time. A person who works for a number of persons or firms at the same time is generally an independent contractor because he is usually free from control by any of the firms. It is possible, however, for a person to work for a number of people or firms and be an employee of one or all of them.

Making Service Available to General Public. The fact that a person makes his services available to the general public usually indicates an independent contractor relationship. An individual may hold his services out to the public in a number of ways: he may have his own office and assistants; he may hang out a "shingle" in front of his home or office; he may hold business licenses; he may be listed in business directories or maintain business listings in telephone directories; or he may advertise in newspapers, trade journals, magazines, etc.

Right to Discharge. The right to discharge is an important factor in indicating that the person possessing the right is an employer. He exercises control through the ever-present threat of dismissal, which causes the worker to obey his instructions. An independent contractor, on the other hand, cannot be fired so long as he produces a result which meets his contract specifications.

Right to Terminate. An employee has the right to end his relationship with his employer at

Exhibit 4640-1 Cont. (4)

Employer-Employee Relationship

any time he wishes without incurring liability. An independent contractor usually agrees to complete a specific job; he is responsible for its satisfactory completion or legally obligated to make good for failure to complete the job.

We have now covered the 20 factors; i.e., does the factor exist. We will now consider the second point: what is the reason for or importance of its existence or nonexistence.

All facts must be weighed, and the conclusion must be based on a careful evaluation of all the facts, IRS published rulings, and the presence or absence of factors which point to an employer-employee relationship or to an independent contractor status.

Take the example of a barbershop. The shop owner may say that he does not control the hours, fix the amount charged for a haircut, or control the barber's cleanliness. However, in determining the weight of each of these factors, the agent should consider the reason for their nonexistence. He may find that the union in effect controls the hours and sets the price for haircuts and that the State Barber Board of Examiners controls the cleanliness of the shop. He correctly concludes, then, that the weight to be given each of these three factors is nothing.

In the case of salesmen, it might be found that the employer does not control the hours of work because, to make a sale, the salesman may have to arrange his hours to fit the customers' hours, such as calling in the evening when the husband and wife are at home. This may be true of other occupations. The important thing is to weigh any factor being considered according to its reason for existence or nonexistence.

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FICA Statutory Employee Rules

In addition to common law employees, the FICA provides for statutory employees, which include (1) agent drivers and commission drivers, (2) full-time life insurance salesmen, (3) home workers, and (4) traveling or city salesmen.